Preliminary Comment

1. Before addressing the Panel's questions, the United States first would like to comment briefly on the exhibits attached to the EC's closing statement of 16 March 2001. If the Panel were to consider this information, it tends to support, rather than undermine, the U.S. position.

2. With respect to EC-19, which consists of a copy of pages from the November 14, 2000 edition of the *Congressional Record* dealing with the floor debate in the U.S. House of Representatives on the bill that became the FSC Replacement and Extraterritorial Income Exclusion Act of 2000 ("the Act"), the United States should clarify for the Panel the significance of floor statements in discerning legislative intent under U.S. law. While in appropriate situations courts may consider floor statements, as a general proposition, floor statements are treated as decidedly inferior to committee reports. This proposition was best expressed by the U.S. Supreme Court – the highest court in the U.S. judicial hierarchy – in *Garcia v. United States*, 469 U.S. 70, 76 (1984) (copy attached as Exhibit US-19), in which the Court stated:

> In surveying legislative history we have repeatedly stated that the authoritative source for finding the Legislature's intent lies in the Committee Reports on the bill, which "represent[t] the considered and collective understanding of those Congressmen involved in drafting and studying proposed legislation." We have eschewed reliance on the passing comments of one Member, and casual statements from the floor debates. In *O'Brien*, we stated that Committee Reports are "more authoritative" than comments from the floor, and we expressed a similar preference in *Zuber* ... . (Citations omitted; bracket in original).

3. A similar principle was articulated by Justice Jackson – of Nuremberg Trial fame – in *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U.S. 384, 395-96 (1951) (concurring) (copy attached as Exhibit US-20), in which he stated:

> Resort to legislative history is only justified where the face of the Act is inescapably ambiguous, and then I think we should not go beyond Committee reports, which presumably are well considered and carefully prepared. . . . [T]o select casual statements from floor debates, not always distinguished for candor or accuracy, as a basis for making up our minds what law Congress intended to enact is to substitute ourselves for the Congress in one of its important functions.

4. Moreover, even when U.S. courts do consider floor statements, they discount statements made by opponents of the legislation. As the Supreme Court stated in *Bryan v. United States*, 524 U.S. 184, 196 (1998) (copy attached as Exhibit US-21): "As we have stated, however, '[t]he fears and doubts of the opposition are no authoritative guide to the construction of legislation.' 'In their zeal to defeat a bill, they understandably tend to overstate its reach.'" (Citations omitted).

5. Thus, if a U.S. court were to consider the floor statements contained in EC-19, the statements to which a court most likely would give weight would be those of Representative Archer, then-chairman of the House Committee on Ways and Means, and Representative Crane, chairman of the Subcommittee on Trade of the House Committee on Ways

and Means, who were important proponents of the Act. The EC does not quote the statements of these gentlemen. Here is what Representative Archer had to say:

> Mr. Speaker, I rise simply to say that the gentleman from California says that it is a corporate subsidy if we do not double tax all of the earnings overseas. We are one of the very few developed countries in the world that double taxes earnings overseas. So if we eliminate partially, only partially, the double taxation of those earnings to be only partially competitive with our foreign competitors, he calls it a subsidy. I do not believe the American people would agree with that.[1]

This statement provides further evidence that Congress intended that the Act serve as a measure to avoid double taxation.

6. With respect to Representative Crane, he made the following statement: "H.R. 4986 moves the U.S. closer to a territorial tax system, more like the one governing the international activities of so many European businesses."[2] This statement provides further evidence that, by means of the Act, Congress consciously intended to incorporate territorial features into the U.S. system of taxation.

7. In a similar vein, the EC's assertions regarding the reluctance of the U.S. Executive Branch officials to speculate on Congress' motives in passing the Act are equally misplaced. To be clear, this reluctance does not stem from the fact that those officials have no knowledge regarding the drafting of the Act, but rather from the fact that any such knowledge is irrelevant for purposes of identifying Congress' intent. Instead, what is relevant is the legislative record created by Congress itself.

8. The Supreme Court has held that *post hoc* observations made by individuals involved in the drafting of legislation carry little weight with respect to discerning statutory meaning. *Bread Political Action Committee v. FEC*, 455 U.S. 577, 582 (1982) (copy attached as Exhibit US-22). According to the Court, these statements have no probative weight because they only "represent the personal views of [the drafter]" and "the statements [a]re made after passage of the Act." *Id.* This is true even if such *post hoc* observations are made by a member of Congress. *Quern v. Mandley*, 436 U.S. 725, 736 (1978) (copy attached as Exhibit US-23).

9. Thus, any *post hoc* speculation of the sort sought by the EC as to what Congress intended would be nothing more than that: mere, and legally irrelevant, speculation.

[1] EC-19, page H11892.
[2] *Id.*, page H11891.

Questions for the United States

Question 7. The United States argues that, with the Act, it changed the general rule of U.S. taxing jurisdiction[3], and thus, in regard to "extraterritorial income", there is no general rule of taxation that would apply "but for" the definition of gross income.[4] The new Section 941(a)(1) of the IRC provides in relevant part:

> **"The term 'qualifying foreign trade income' means, with respect to any transaction, the amount of gross income which, if excluded, will result in a <u>reduction of the taxable income</u> of the taxpayer from such transaction...."(emphasis added)**

How can the US argument be reconciled or harmonized with the underlined words quoted above?

10. The above statements do not conflict. The reduction of taxable income referred to in the statute is the intermediate step in a formula for computing the amount of excluded income. Use of that intermediate step does not indicate that excluded income would be otherwise subject to tax in the United States.

11. A basic principle of U.S. tax law is that a taxpayer may deduct the expenses it incurs in producing taxable income. A corollary to that principle is that a taxpayer may not deduct the expenses it incurs in producing income that is excluded from the tax base. To permit otherwise would allow a taxpayer to underpay its taxes.

12. The exclusion for extraterritorial income is an exclusion from gross income, not a reduction in taxable income. Under the U.S. tax system, gross income refers to the income of the taxpayer without taking into account any deductions. Because excluded extraterritorial income is excluded from the U.S. tax base, however, the Act denies deductions attributable to such income. This presents a computational problem: how are disallowed deductions to be removed if the excluded amount is based on gross income, which does not account for any deductions? The problem is solved by first computing taxable income, then denying deductions allocable to excluded extraterritorial income, and then "grossing up" the resulting figure into a gross income exclusion by attributing to the taxable income amount any allocable deductions. The legislative history of the Act provides the following summary: "[I]n order to calculate the amount that is excluded from gross income, taxable income must be determined and then "grossed up" for allocable expenses in order to arrive at the appropriate gross income figure."[5] A comprehensive numerical example of this process is contained in the legislative history of the Act.[6]

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[3] **US first submission, para. 72.**
[4] **US first submission, para. 77.**
[5] *Senate Report* (US-2), page 12.
[6] *Id.*, pages 11-14.

13. Thus, the exclusion for extraterritorial income is an exclusion from gross income, and the step of converting the amount of the exclusion into a reduction in taxable income is only a mechanism for determining the amount of the gross income exclusion.

14. More generally, one practical effect of any exclusion is that it has the ultimate effect of reducing taxes from what they would have been without the exclusion. This same issue arises in connection with exemption systems. To recognize this fact is separate from the question whether exclusion is part of a country's general rule of taxation.

15. In this regard, in an oral follow-up question, the Panel asked whether Question 33 is relevant to Question 7. The United States does not believe that the Treasury subpart F study is relevant to the formula for calculating excluded extraterritorial income.

Question 8. The European Communities states that, in order for extraterritorial income to be excluded from taxation, "US articles must be used whenever the cost of other inputs (not articles or direct labour) (C) and profit (D) are less than 50% of the selling price (or more exactly the US-assessed fair market value) of the goods".[7] Is this a correct characterisation of Act ? If not, could the US provide what it considers to be the correct description?

16. This is not a correct characterization of the Act. U.S. articles do not have to be used in this situation because U.S. labor could be used to meet the 50% limitation without increasing the amount of U.S. articles. For example, assume that the EC's (C) and (D) account for 49% of the fair market value, leaving 51% to be accounted for by articles and labor. Under the Act, all but 1% of that 51% could be accounted for by foreign labor and articles, while the remaining 1% could be accounted for by U.S. labor.

17. More generally, however, the EC has narrowed inappropriately the scope of the relevant question. The more appropriate question is whether the Act contains an affirmative requirement to use U.S. articles. There is no such requirement in the Act.

18. This inaccurate description of the Act reflects the EC's limited understanding of the Act's structure and design. In this regard, the EC's algebraic breakdown fails to reflect the Act's distinction between the foreign labor and U.S. labor components.

[7] **EC first submission, para. 112.**

Question 9. In the Annex to its first and second submissions, the European Communities identifies cases where the cost of "articles" used to produce finished goods exceeds 50% of the value of the finished product, a situation in which the "requirement to use US articles must arise in practice".[8] How does the US respond to this allegation? Are such situations precluded by virtue of the Act ?

19. It is clearly possible to construct a hypothetical showing that the 50 percent rule might not be satisfied in some situations. The EC claims that its hypotheticals are based on actual data, but, not having access to the data, the United States is unable to respond to the accuracy of the data or the validity of the conclusion derived by the EC from the data. The United States would note that it has been informed by a reliable source that the EC's percentage figures for aircraft engines and avionics are too high. From that, the United States can only assume that the other figures cited by the EC also may be inaccurate.

20. In an oral follow-up question, the Panel asked whether, if a particular company can only satisfy the 50 percent rule by using U.S. articles, the taxpayer is automatically entitled to the exclusion? The answer to this question is "no", satisfaction of the 50 percent rule through the use of U.S. articles would not guarantee eligibility for the Act's exclusion with respect to income from the sale of the finished product. The taxpayer still would have to satisfy all of the other requirements of the Act, such as the foreign economic process requirements of section 942(b).

Question 10. The European Communities submits[9] that "the term "export" in Article 3.1(a) of the SCM Agreement refers to the sale of:

- **Goods;**
- **Originating in the country providing the subsidy;**
- **Destined for the market of, that is for final consumption in, another country."**

Does the US agree with this definition of the term "export" for the purpose of the SCM Agreement?

21. The United States does not agree with this definition. The United States believes that the EC got the definition right the first time, when it followed the dictionary definition: "Send (esp. goods) to another country".[10] Thus, based on the ordinary meaning of "export", where a good is ultimately consumed is irrelevant to whether it is exported, and a product can be exported multiple times until it is finally consumed. The EC offers no support for its assertion that the ordinary meaning of "export" should be ignored.

[8] EC first submission, para. 116.
[9] EC first submission, para. 91.
[10] EC submission, para 85.

Question 11. Where qualifying foreign trade property is manufactured, produced, grown or extracted within the United States, is there a possibility under the Act for a taxpayer to exclude any amount of gross income earned from the sale of a good - thus resulting in the reduction of its taxable income - if such a transaction does not involve the exportation of the said good from the United States into any other country?

22. Yes. A manufacturer of goods can earn excluded income by sales to domestic buyers, provided that the goods in question are used outside the United States. Use outside the United States could occur, for example, if the good in question is a fishing boat sold to a United States person for use outside the territorial waters of the United States. In that case, income from the sale of the boat could qualify notwithstanding that the boat was not "consumed" within a foreign jurisdiction. Use outside the United States also could occur in certain circumstances if the article is incorporated into a good that is sold for use outside the United States. Thus, for example, extraterritorial income could be earned if a U.S. manufacturer sells an aircraft engine to a U.S. aircraft manufacturer for incorporation into a finished aircraft to be used outside the United States. The foregoing examples follow from the language of the statute, but the precise scope of these rules will be the subject of proposed regulations to be issued in the future.

23. In an oral follow-up question, the Panel asked whether there is no way to benefit from the exclusion if the final destination of a good is the United States, and whether a good must cross the border before final use?

24. With respect to the first question, taxpayers may earn excluded extraterritorial income with respect to some transactions in which the "final destination" of the property is the United States. The legislative history provides as follows:

> [P]roperty that is sold to an unrelated person as a component to be incorporated into a second product which is produced, manufactured, or assembled outside of the United States will not be considered to be used in the United States (even if the second product ultimately is used in the United States), provided that the fair market value of such seller's components at the time of delivery to the purchaser constitutes less than 20 percent of the fair market value of the second product into which the components are incorporated (determined at the time of completion of the production, manufacture, or assembly of the second product).[11]

Thus, for example, a U.S. manufacturer of car tires may earn excluded extraterritorial income from the sale of tires to an unrelated U.S. car manufacturer with a plant in Canada, even if the tires are installed on cars for sale in the U.S. domestic market.

25. In addition, the foreign use requirement only requires *predominant* foreign use. Thus, some domestic use is permitted. According to the legislative history,

[11] *Senate Report* (US-2), page 19.

property is considered to be used predominantly outside the United States for any period if, during that period, the property is located outside of the United States more than 50 percent of the time.[12]

26. With respect to the second question, the Act does not generally require any border crossing. For example, a taxpayer may earn excluded income with respect to foreign-produced property that is produced and consumed within the same foreign jurisdiction.

Question 12. Where qualifying foreign trade property is manufactured, produced, grown or extracted within the United States by a US corporation or an individual permanently established in the United States, and where that corporation or individual does not maintain any permanent establishment outside the United States, are there situations in which extraterritorial income earned from the sale of such property can be taxed by another country than the United States ?

27. The United States believes that there are such situations, and the Act was designed to account for them. The United States, for example, subjects foreign persons to tax that do not have a permanent establishment in the United States.

28. The United States unfortunately is not in a position to opine regarding all the tax laws of the world. The United States would cite, however, certain examples of countries with which the United States has no income tax treaty and which may impose source-based taxation under domestic law in the absence of a permanent establishment:

- Brazilian domestic law does not contain a proper definition of the term "permanent establishment." In fact, there are no rules providing for special tax treatment of permanent establishments in Brazil.[13]
- Chilean source income is taxable in Chile even if it is earned by a non-resident with no establishment or agency in Chile. Chilean law does not provide for the concept of a permanent establishment. Chilean-source income is taxable even on occasional transactions.[14]
- Malaysia taxes non-residents on income accruing in or derived from Malaysia. The concept of permanent establishment is not part of Malaysian internal revenue law.[15]

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[12] *Id.*, page 20.

[13] International Bureau of Fiscal Documentation, *Taxation in Latin America*, Section C, Brazil 21-23 (LA, Suppl. No. 121, September 2000) (copy attached as Exhibit US-24).

[14] International Bureau of Fiscal Documentation, *Taxation in Latin America*, Section C, Chile 23, 26 (LA, Suppl. No. 117, September 1999) (copy attached as Exhibit US-25).

[15] International Bureau of Fiscal Documentation, *Taxation and Investment in Asia and the Pacific*, Malaysia 33-34, 38, 43 (AP, Suppl. No. 189, May 2000) (copy attached as Exhibit US-26).

- Panamanian-source income is subject to tax in Panama even if it is earned by a non-resident with no establishment or agency in Panama. Such income paid to non-residents is subject to a withholding tax. Whether or not income is Panamanian-source income does not depend on the nationality, domicile, or residence of the recipient, nor on the location at which the contract is concluded. Panamanian law does not recognize the concept of "permanent establishment".[16]
- Taiwan imposes income tax on all income derived from sources within Taiwan, whether earned by residents or non-residents. Taiwanese law does not use the term "permanent establishment". If a foreign individual or foreign "profit-seeking enterprise" without a "fixed place of business" or a "business agent" earns income in Taiwan, the income is subject to a final withholding tax.[17]
- Saudi Arabia levies tax on all income from Saudi Arabian sources. This is the case even in cases where the foreign entity has no presence in Saudi Arabia, and thus the government has no power to compel the foreign entity to file a tax return. In such cases, the payor of the income is liable for the tax, which is thus essentially transformed into a withholding tax. There is no concept of "permanent establishment" in Saudi Arabian law.[18]

The United States emphasizes that these are only a few examples of countries that do not provide for the concept of a permanent establishment in their domestic tax law.

29. Thus, the concept of a "permanent establishment" is not a universally adopted standard, as the EC suggests. Territorial systems do not define the scope of the exemption based upon the amount of income attributable to a foreign permanent establishment. Territorial systems simply exclude income earned outside the territorial boundaries of the country in question.

30. There are additional, independent reasons to reject the EC's approach. First, the United States recalls that it has income tax conventions with only 63 countries, leaving U.S. business to face the domestic tax laws of all other countries without the benefit of a permanent establishment article.

31. Second, the EC's argument is internally inconsistent. If the concept of permanent establishment were an internationally accepted standard, as the EC alleges, then there would be no need for Article 7 of the OECD model, which is designed to override the domestic laws of the signatories to a tax treaty.

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[16] International Bureau of Fiscal Documentation, *Taxation in Latin America*, Section C, Panama 4, 13, 14-16 (LA, Suppl. No. 113, March 2000) (copy attached as Exhibit US-27).

[17] International Bureau of Fiscal Documentation, *Taxation and Investment in Asia and the Pacific*, Taiwan 17, 19 (AP, Suppl. No. 111, November 1993) (copy attached as Exhibit US-28).

[18] International Bureau of Fiscal Documentation, *Taxation and Investment in the Middle East*, Saudi Arabia 43-46 (ME, Suppl. No. 90, August 2000) (copy attached as Exhibit US-29).

32. Third, the EC's argument is counter-textual. Even assuming that the concept of a permanent establishment were an internationally accepted standard, which it is not, footnote 59 nowhere refers to the term "permanent establishment", and nothing in footnote 59 states that a measure qualifies as a measure for the relief of double taxation only if it conditions relief upon the existence of a permanent establishment.

33. Fourth, validation of the EC's argument would be unwise, given the evolving standards for when double taxation may arise. Take the example of the recent developments in e-commerce. With respect to cross-border electronic transactions, the definition of permanent establishment is the subject of an ongoing debate. Different countries have taken different positions on what degree of activity constitutes a permanent establishment, giving rise to the spectre of double taxation despite the absence of a permanent establishment.

34. Accordingly, the approach suggested by the EC is unwise and unwarranted.

Questions for Both Parties

Question 13. Regarding the relationship between Article 3.1(a) of the SCM Agreement and item (e) of Annex I, would it be possible that a certain measure is not within the scope of the latter, but nonetheless within the scope of the former, and *vice versa*?

35. The United States explained its position on the relationship between paragraph (e) of Annex I and Article 3.1(a) at paragraphs 157-61 of its First Submission. There, the United States pointed out that paragraph (e) identifies a particular type of prohibited export subsidy - that is, a particular type of subsidy made contingent on export performance.

36. The United States made its comments in response to the EC argument that paragraph (e) broadens Article 3.1(a) and prohibits export subsidies that are not within the scope of 3.1(a). The United States recalled that, as a part of the Illustrative List of Export Subsidies, paragraph (e) provides an example of a prohibited export subsidy. The United States maintained, and remains of the view, that paragraph (e) helps to clarify and apply 3.1(a), but it does not prohibit something that 3.1(a) does not. The United States notes that the panel in the *Canada Autos* case appears to have taken a similar view.[19]

37. The key issue seems to be that the EC wants the Panel to find that the fact that a measure is available to exports is enough to violate the SCM Agreement. The United States submits that

[19] *Canada - Certain Measures Affecting the Automotive Industry*, WT/DS139/R, WT/DS142/R, Report of the Panel, as modified on other grounds by the Appellate Body, adopted 19 June 2000, para. 10.196 ("Indeed, the use of the words 'including' and 'illustrated' makes it clear that, while all practices identified in the Illustrative List are subsidies contingent upon export performance, there may be other practices not identified in the Illustrative List that are also subsidies contingent upon export performance."). This particular aspect of the panel report was not appealed.

this cannot be the case. A tax exemption, remission, or deferral that is "specifically related to exports" requires a much closer connection to exportation than mere availability. The Panel need not even explore the relationship between paragraph (e) and Article 3.1(a) if that is the EC's theory. Even if such an attenuated connection could equal "specifically related to exports", the United States believes the connection to exports must still amount to a contingency. If not, then no violation of Article 3.1(a) can be shown.

Question 14. The Panel is well aware that the WTO-conformity of income tax regimes of European countries is outside the scope of our terms of reference for this case. In paragraph 96 of the US first submission, the US introduces examples of a few European tax systems which "refrain from taxing foreign income in a qualified or conditional manner."[20] Among those systems, is there one which excludes foreign income from the scope of taxable income on the following conditions:

(i) the property for sale from which income arises must be held for ultimate use outside the country, (and not be sold for final consumption in that country); and

(ii) the same property must have foreign content of not more than a certain percentage of its fair market value.

38. With respect to condition (i), every country that declines to tax income that domestic corporations earn outside the territory as fully as the income they earn domestically provides those companies a tax incentive to export. This is because any domestic corporation that exports and that can attribute some portion of the export income to offshore activities can, by virtue of territorial features found in certain European tax systems, be taxed at lower rates in the foreign jurisdiction. Exporters throughout Europe are keenly aware of this benefit and plan their business activities accordingly.

39. The conditions for taking advantage of this tax incentive in these European countries are similar, but not identical, to those in the Act. If a domestic corporation manufactures products domestically, it can earn exempt income only by exporting (a condition that is similar, but not identical, to the Act's requirement of a foreign sale). As a practical matter, in European countries that use the exemption method, it is undoubtedly the case that the primary beneficiaries of the exemption are exporters.

40. With respect to (ii), which is a feature of the Act that rarely comes into play, the United States is not aware of a similar provision in a European country. The U.S. provision is probably unique.

Question 15. Is the term "foreign-source income," "foreign-source" or "source" used elsewhere in any provisions of other WTO Agreements than the SCM Agreement? What

[20] **US first submission, para. 97.**

guidance, if any, may be drawn as to the meaning of these terms from the SCM Agreement or other WTO Agreements?

41. We have found two places in the Covered Agreements in which some or all of the above words are used. In paragraph 1(a) of the Annex to the Agreement on Trade-Related Investment Measures, the word "source" is used in reference to domestic content requirements. Specifically, the reference is to "the purchase or use by an enterprise of products of domestic origin or from any domestic <u>source</u> ... ." (Emphasis added). The use of "source" in this context appears to refer not to a situation in which a Member conditions an investment opportunity based on a requirement that goods be manufactured within its borders, but rather that goods be purchased from a domestic business or person (regardless of where the goods are made).

42. This use of "source" is consistent with the U.S. position regarding the fifth sentence of footnote 59. The United States has noted that one attribute of income that may render it "foreign-source income" is that the purchaser of the good is foreign or the source of payment is foreign. The use of the term "source" in the TRIMs Agreement parallels this understanding of "source" in footnote 59.

43. Another reference is found in Article XIV of the General Agreement on Trade in Services, which provides as follows:

> [N]othing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures:
>
> ...
>
> (d) inconsistent with Article XVII [national treatment], provided that the difference in treatment is aimed at ensuring the equitable or effective [6] imposition or collection of direct taxes in respect of services or service suppliers of other Members.[21]

44. Footnote 6 to Article XIV(d) states in relevant part as follows:

> Measures that are aimed at ensuring the equitable or effective imposition or collection of direct taxes include measures taken by a Member under its taxation system which:
>
> (i) apply to non-resident service suppliers in recognition of the fact that the tax obligation of non-residents is determined with respect to taxable items <u>sourced</u> or located in the Member's territory ; or

[21] "Direct taxes" is defined in GATS Article XXVIII to "comprise all taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation." This definition of "direct taxes" is slightly different from, but not inconsistent with, the definition of "direct taxes" found in footnote 58 of the SCM Agreement.

> ...
>
> (iv) apply to consumers of services supplied in or from the territory of another Member in order to ensure the imposition or collection of taxes on such consumers derived from sources in the Member's territory; or
>
> ...
>
> (vi) determine, allocate or apportion income, profit, gain, loss, deduction or credit of resident persons or branches, or between related persons or branches of the same person, in order to safeguard the Member's tax base.
>
> Tax terms or concepts in paragraph (d) of Article XIV and in this footnote are determined according to tax definitions and concepts, or equivalent or similar definitions and concepts, under the domestic law of the Member taking the measure. (Emphasis added.)

45. The purpose of paragraph (d) and its explanatory footnote is to make clear that, with respect to the taxation of service income, Members are entitled to depart from the normal rule of national treatment to ensure the "equitable or effective imposition of direct taxes". In other words, Members are permitted to take special measures to prevent evasion that might otherwise occur as a result of the foreign location of service suppliers or the foreign performance of services. A key point in footnote 6 for purposes of the present dispute is the fact that the final sentence provides that the tax terms used in the relevant text do not have universally agreed upon meanings. Thus, the final sentence indicates that the negotiators of GATS wanted to provide flexibility to capture the various instances in which income can be regarded as "sourced" within a Member.

46. An equally important point is that the drafters understood that taxes can be derived from sources in myriad ways. They recognized that WTO Members use different sourcing rules and have different jurisdictional boundaries. Thus, what one country might deem to be taxable income, another might view as outside the scope of its tax system. At a minimum, this language in the GATS indicates that the EC's "foreign economic processes test" is too narrow. For example, subpart (iv) makes clear that Members may tax income of foreign service providers by levying taxes on domestic customers where the services in question are "supplied in or from the territory of another Member". That such a service can be "sourced" within the country of the customer means that a "foreign economic processes test" is too rigid to capture the complexities of modern international business and taxation.

47. In other words, the drafters of the GATS, like the drafters of the SCM Agreement, wanted the term "source" to be given its ordinary meaning. "Source" may mean different things depending on the context in which it is used. They did not intend for it too have one unique

meaning to be applied in all cases.[22] They also did not intend to incorporate an extrinsic definition of the term, including the "special meaning" of "foreign source income" the EC claims exists in the OECD Convention. The United States has previously noted that the OECD Convention contains no definition of foreign-source income and recognizes that income that is not attributable to any foreign economic processes – i.e., passive income derived from foreign "sources" – may be exempted from taxation.[23]

48. Finally, the United States notes that Article XIV(e) and Article XXII:3 of GATS confirm the flexibility built into the fifth sentence of footnote 59. Article XIV(e) provides an exception from Article II (MFN) where "the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the Member is bound." Article XXII:3 provides that a Member may not invoke Article XVII (national treatment) under the GATS dispute settlement provisions "with respect to a measure of another Member that falls within the scope of an international agreement between them relating to the avoidance of double taxation." These provisions create an exception to GATS non-discrimination rules only to the extent that the relief of double taxation is provided for or allowed by another agreement. Footnote 59 contains no such limitation. Whether and how to avoid double taxation are questions left to individual WTO Members.

[22] Because the fifth sentence of footnote 59 speaks of not imposing limits on the ability of a WTO Member to take measures to avoid double taxation, the United States believes that the term "foreign source income" in the context of footnote 59 should be interpreted broadly. A broad interpretation in this case would account for the real possibility that a foreign jurisdiction could tax excluded extraterritorial income. As noted before, the United States believes that extraterritorial income has many attributes that make it "foreign" and, as a result, it could be subject to foreign tax. If the Panel were to adopt the EC's cramped interpretation of foreign-source income here, the Panel's ruling would have the effect of preventing Members from relieving double taxation in certain cases as a matter of WTO law.

[23] If the drafters of the SCM Agreement had intended to incorporate the OECD Convention in the fifth sentence of footnote 59, they would not have done so silently. By contrast, item (k) of Annex 1 contains a specific reference to extrinsic sources. Item (k) of Annex I refers to "an international undertaking on official export credits to which at least 12 original Members to this Agreement are parties as of 1 January 1979 (or a successor undertaking which has been adopted by those original Members)". The United States is aware of only one undertaking that meets this description, and it is the OECD Arrangement on Guidelines for Officially Supported Export Credits. Thus, the fact that the drafters of the SCM Agreement did not tie the fifth sentence of footnote 59 to extrinsic documents cannot be assumed to be "merely accidental or an inadvertent oversight on the part of either harassed negotiators or inattentive draftsmen." *United States - Restrictions on Imports of Cotton and Man-made Fibre Underwear*, WT/DS24/AB/R, Report of the Appellate Body adopted 25 February 1997, page 17.

In this regard, at the meeting with the Panel, the Panel asked whether the reference in the fourth sentence of footnote 59 to bilateral tax treaties and the OECD suggests that the drafters intended extrinsic documents to apply for purposes of the fifth sentence. In the view of the United States, the answer to this question is "no." Indeed, the absence of a similar reference in the fifth sentence suggests the opposite conclusion; *i.e.*, that the drafters did not intend to incorporate standards or definitions from extrinsic sources.

49. In an oral follow-up question posed at the Panel meeting, the Panel asked whether the Appellate Body's references to "foreign-source income" in its report in the *FSC* case have any relevance to the instant proceeding?

50. While the Appellate Body did not define the term "foreign-source income" within the context of footnote 59, it did apply the term broadly and did not tie the concept to a particular Member's tax law. More generally, the Appellate Body reaffirmed that Members have the right not to tax a particular category of foreign-source income.[24] This reaffirmation supports the U.S. position, which is that excluded extraterritorial income is a category of "foreign-source income" that the United States has chosen not to tax. By contrast, the EC appears to argue that a Member cannot refrain from taxing foreign-source income unless it decides to refrain from taxing *all* foreign-source income. Under the EC view, anything less than a full exclusion would give rise to an "exception" from a "general rule" of taxation. The Appellate Body's opinion demonstrates that the EC's argument is without merit.

51. Moreover, the EC's approach is incoherent at best. The EC seems to ask the Panel to rule that the term "foreign-source income" has whatever meaning assigned to it by U.S. domestic law. This approach proves the U.S. case, because excluded extraterritorial income would be foreign-source income under U.S. sourcing rules, as set forth in section 862(a)(4) and 863(b) of the IRC. Nevertheless, the United States notes that the EC's approach is internally inconsistent because the EC simultaneously asserts that the income in question must be subject to tax under foreign law. Unless the EC is prepared to assert that the entire world employs the U.S. domestic-law sourcing rules, then the EC must admit that these two approaches to determining source often will generate different results. The difference between U.S. sourcing rules and foreign sourcing rules reflects the basic fact that no general international consensus exists on how best to source income from cross-border transactions, transactions such as those that generate excluded extraterritorial income. Despite the absence of such a consensus, the EC is inviting the Panel to impose one rule – with no relevant theoretical justification – upon the tax authorities of all WTO Members.

Question 16. The European Communities claims that[25]:

> **"Even if it were a measure to avoid the double taxation of foreign-source income, the FSC Replacement Act would in any event be contrary to Article 3.1(a) of the SCM Agreement because it gives exporters a *choice* that is not available to other operators.... This additional advantage would also be a subsidy,.... This unwarranted *overcompensation* is also a subsidy....**
>
> **(For the EC): Please provide a textual analysis of how the alleged *additional advantage* and *overcompensation* constitute subsidies under Article 1 of the SCM Agreement.**

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[24] *FSC (AB)*, para. 99.

[25] **EC second submission, paras. 221-222.**

(For the US): How does the US respond to this allegation?

52. The United States explained in paragraphs 35-38 of its Second Submission why countries can and do rely on alternative methods of avoiding double taxation. This is a common and well-accepted practice. For example, in France, with the permission of the Ministry of Economy and Finance, a French company may elect to be taxed on its worldwide income and obtain relief from its worldwide losses. Thus, in the context of export subsidies, alternative methods of double taxation relief should be irrelevant, especially where no unique or special benefits are provided exclusively to exporters. This is the case with respect to the Act, which is not uniquely applied to exporters or export income.

Question 17. The EC seems to argue that a Article 3.1(b) violation may exist if a certain measure gives an "incentive" to domestic production for export.[26] In the same vein, the EC argues that "Article 3.1(b) prohibits local-content contingency to <u>any</u> degree,... [and] there is no *de minimis* rule for prohibited subsidies in the SCM Agreement.".[27]

(For the EC): How would this argument be supported by a textual analysis of Article 3.1(b) in accordance with Article 31 of the *Vienna Convention*? Can the European Communities cite any Appellate Body or panel reports in which the term "incentive" was explicitly used in the context of Article 3.1 of the SCM Agreement, or Article XVI:4 of the GATT Agreement?

(For the US): Would a textual analysis of Article 3.1(b) lead to a conclusion that the EC's above argument is without merit? If so, why and how? Would the US take the view that there is *de minimis* rule for prohibited subsidies in the SCM Agreement? If so, what is the qualitative or quantitative threshold for that rule? Is the Appellate Body Report in *Canada - Certain Measures Affecting the Automotive Industry*[28] relevant to this question? Please give reasons for your responses.

53. The EC's "textual" analysis of Article 3.1(b) is incomplete. The EC notes that the dictionary (which for some reason known only to the EC is useful here but not in connection with other parts of the SCM Agreement) defines "over" as "in preference to". However, instead of interpreting "in preference to", the EC decides to abandon the dictionary and simply equates "preference" with "incentive" or "boost." However, the same dictionary relied on by the EC – *The New Shorter Oxford English Dictionary* – defines "in preference to" as "rather than."

54. Thus, a textual analysis would lead to the conclusion that the EC's argument is without merit. The key words in Article 3.1(b) are "contingent" and "use." "Contingent upon the use of domestic goods" simply is not the same thing as "incentive to use domestic goods."

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[26] ***See* EC first submission, para. 165.**
[27] **EC second submission, para. 160.**
[28] **WT/DS130/AB/R, WT/DS142/AB/R.**

55. With respect to the second part of the question, the question omits part of the quoted phrase; i.e., the phrase "even a slight bias in favour of domestic goods." In the view of the United States, "a slight bias" is not a contingency. A measure – at least a measure challenged on a *de jure* basis – either is contingent or it is not. The United States is not arguing that a *de minimis* contingency is permissible under Article 3.1(b); rather, the United States is arguing that a "slight bias" or incentive does not amount to a contingency. For these reasons, the United States does not see how the *de minimis* concept relates to a determination of contingency.

56. As for *Canada Autos*, the United States considers the Appellate Body report extremely relevant. In that case, the Appellate Body said that value-based requirements cannot automatically be deemed as creating a contingency within the meaning of Article 3.1(b). Instead, there must be an analysis of how the requirements operate for individual manufacturers. In the view of the United States, the EC has failed to demonstrate that the 50-percent rule actually requires any manufacturer, whether located in the United States or abroad, to use U.S. articles.

57. In this regard, the EC is making the same argument regarding Article 3.1(b) as the one rejected in *Canada Autos*; namely, that the standard of Article 3.1(b) is satisfied if a measure "favors or gives preference to the use of domestic over imported goods."[29] Neither the panel nor the Appellate Body accepted this interpretation. Although the Appellate Body did not expressly reject this interpretation, it is clear from the report that the Appellate Body implicitly rejected it. The Appellate Body's analysis set forth in paragraphs 126-131 indicates that a "slight bias" is not enough to establish a contingency for purposes of Article 3.1(b). Instead, it is necessary to analyze how value-based requirements operate for individual manufacturers.

Question 18. Relating to Article III:4 GATT, EC has cited[30], *inter alia*, the Panel Report on *Italian Discrimination against Imported Agricultural Machinery*.[31] We note that two other documents -- GATT Doc. L/695 (1957) and GATT Doc. L/740 (1957) -- address similar issues. Are these relevant to the question of whether Article III:4 of the GATT in the first place covers exemptions to the tax on the "firm"? Please comment on whether and how these reports are relevant to our case.

58. These cases appear distinguishable on their face from the present dispute. At the most basic level, these cases involved programs that applied directly to products. The governments provided subsidized financing or grants that could only be used for the purchase of domestic products. Because like imported products were ineligible for similar financing, the programs violated the national treatment provisions of GATT Article III:4. By contrast, the present case does not deal with a measure that directly affects products, but rather, income taxes. A closer analogy to the agricultural machinery financing cases would exist if a country imposed differing

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[29] This argument is reflected in para. 10.214 of the panel report and para. 119 of the Appellate Body report in *Canada Autos*.

[30] **EC first submission, para. 98.**

[31] **GATT Doc. L/833 (1958), adopted 23 October 1958, BISD 7S/60.**

levels of excise tax on imported, as opposed to domestic, products; such a case would properly be brought under Article III:2, rather than Article III:4.

59. Indeed, there is support in the history of the GATT that Article III:4 was never intended to apply to income taxes. The Reports of the Havana Convention, at which Article 18 of the Havana Charter[32] (the immediate predecessor to GATT Article III, with essentially identical text) was drafted, specify that "neither income taxes nor import duties fall within the scope of Article 18 which is concerned solely with internal taxes on goods."[33] It is striking that in over 50 years of GATT and WTO jurisprudence, few cases have been brought that alleged that income tax measures violated Article III:4 [34], and there have been no panel decisions on the issue. A WTO panel, expounding generally on the scope of Article III, noted in passing that, "subsidies granted in respect of direct taxes are generally not covered by Article III:2, but may infringe Article III:4 to the extent that they are linked to other conditions which favor the use, purchase, etc. of domestic products."[35] This statement is purely *dicta*, because none of the measures within the panel's terms of reference involved an income tax.

Questions for the United States

Question 19. The United States appears to contend that, when a company manufactures goods in the United States and sells them abroad, the income generated may be partly domestic-source and partly foreign-source. If so, is it not equally true that, when a company manufactures goods abroad and sells them in the United States, the income generated may also be partly domestic-source and partly foreign-source? If so, and given your assertion that the Act is a measure to avoid the double taxation of foreign-source income, please explain why the exclusion provided by the Act for "extraterritorial" income is limited to instances where property is sold or leased for use outside the United States.

60. Depending on the circumstances, a portion of the income would be U.S.-source income and a portion would be foreign-source income. The extraterritorial income exclusion, however, is limited to the foreign-source income that arises when property is sold or leased for use outside

[32] Final Act of the United Nations Conference on Trade and Employment, March 24, 1948.

[33] Interim Committee for the International Trade Organization, *Report of Committees and Principal Sub-Committees,* Report of Sub-Committee A of the Third Committee on Articles 16, 17, 18 and 19, E/CONF./2/C.3/59, para 44, page 63, Geneva, 1948.

[34] The *Analytical Index, Guide to GATT Law and Practice,* Vol. 1, Geneva, 1995 cites a 1952 complaint by Austria that Italy granted a remission of income tax to firms that used domestically-produced ship's plate, L/875; a 1971 Working Party on the United States Temporary Import Surcharge held an exchange of views on the Job Development Tax Credit, a credit against United States income taxes which was allowed only on domestically-manufactured equipment, L/3575; and a 1987 EEC complaint concerning the temporary extension of tax credits and depreciation for passenger aircraft assembled in certain U.S. states, L/6153.

[35] *Indonesia - Certain Measures Affecting the Automobile Industry,* WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, Report of the Panel adopted 23 July 1998, para. 14.38.

the United States because the United States has determined not to cede primary taxing jurisdiction over U.S.-source income. Thus, in the case of a foreign person that earns U.S.-source income from sales in the U.S. domestic market, the United States would retain primary taxing jurisdiction over such income, and relief from double taxation would be left to the foreign jurisdiction to provide. In this respect, the Act provides parallel treatment with the exemption method. Just as the United States generally cedes taxing rights over excluded extraterritorial income, so, too, would a foreign exemption system generally cede taxing rights over U.S.-source income in the case of a foreign person earning U.S.-source income from sales in the U.S. domestic market.

61. More generally, however, nothing in footnote 59 requires that a measure for the relief of double taxation resolve the problem of double taxation completely or precisely. Footnote 59 provides that paragraph (e) "is not intended to limit" a Member from taking measures to avoid double taxation. Indeed, it is highly unlikely that any system for the relief of double taxation would result in the complete elimination of double taxation without creating instances of double non-taxation. Such precision is probably impossible, given the many differences in taxation systems from one country to another and the many different ways that international commerce can be structured. This persistent problem in melding different systems is one reason that the OECD has provided only general guidelines regarding the relief of double taxation. It is also the reason that the United States suggests that the panel should not attempt to impose a single interpretation of the term "foreign-source" income in footnote 59. To interpret footnote 59 in the way suggested by the EC would effectively dictate to countries the manner in which they must structure their domestic tax systems with respect to international activities. It is safe to say that the drafters of the footnote had exactly the opposite goal, which was to allow Members to continue to determine how best to avoid double taxation of income.

Question 20. Assume that the US legislation provided that: "Gross income does not include income generated from export activities". Would there be revenue foregone which is "otherwise due" such that there was a financial contribution within the meaning of Article 1? How, if at all, would you distinguish this situation from the exclusion of "extraterritorial income" from gross income under the Act?

62. The ordinary meaning of the terms of Article 1.1(a)(ii) suggests that in such a situation there would <u>not</u> be a financial contribution within the meaning of Article 1.1(a)(1). This is because the tax revenue on export activities would not be "otherwise due" under the law of the Member, which is the normative benchmark for an Article 1 analysis. Although this would arguably permit countries to exclude narrow categories of income from tax if they were willing to so modify their general rule of taxing authority, it is the reading that the ordinary meaning of the terms most directly suggests.

63. If the Panel believes that it is necessary to depart from the ordinary meaning of Article 1 and to interpret it more broadly, the only defensible broader interpretation, we believe, would be that gross income (or a comparable concept in a country other than the United States) can be defined in any manner that a sovereign state chooses, <u>except</u> that if the general rule creates an

exclusion that is expressly specific within the meaning of the meaning of Article 2, then that exclusion would constitute a financial contribution within the meaning of Article 1.1(a). Under this interpretation, an exclusion that was applicable only to a specific universe of firms, as defined by Article 2, would constitute a financial contribution, and thus a subsidy, within the meaning of Article 1.

64. The reason that a broader interpretation would not be defensible is that if the exclusion were not expressly specific, then panels would have to determine what generic exclusions, of which some specific group was a part, would cause the exclusion to be a financial contribution. This would be impractical because in any given case, the mix of users from a specific group and users from a non-specific group could range from one end of the spectrum to the other. Would, for example, territorial limits constitute a financial contribution if it were shown that 30 percent of the beneficiaries of territorial limits were exporters? 70 percent? 95 percent? There would be no criteria by which rational line-drawing in such a situation could be done.

65. Hence our answer is: (a) the ordinary meaning of the text suggests that the answer to the Panel's question 20 is "no"; (b) if the ordinary meaning is considered unacceptable, a broader reading of the text could find that an exclusion incorporated into a general rule would constitute a financial contribution if the exception were expressly applicable to only a specific group; and (c) any broader rule would not be principled or workable.

66. If the Panel were to apply our alternative broader principle to this case, we do not believe that the Act's exclusion would be specific within the meaning of Article 2.3, because, for the reasons previously articulated, the exclusion is neither export contingent nor contingent upon the use of domestic over imported goods. Similarly, there has been no allegation made, or evidence submitted, that the exclusion is specific within the meaning of Articles 2.1 or 2.2, and we do not believe that any sort of credible case could be made that it is.

Question 21. Assume that the "qualified" exemptions from taxation of foreign-source income described in paragraph 96 of the United States' first submission are "subsidies" within the meaning of Article 1 of the SCM Agreement. Would such subsidies be specific within the meaning of Article 2?

67. The United States has two answers: one based on the U.S. approach and one based on the EC approach.

68. The qualified exemptions created by territorial limits in European tax systems are, for purposes of specificity, similar to the new U.S. legislation. In our opinion, neither the European exemptions nor the exclusion in the U.S. Act is specific, for the reasons that follow.

69. For purposes of discussion let us assume, as the EC asserts will be the case, that most of the U.S. taxpayers that will take advantage of the Act's exclusion are exporters. Let us also assume for purposes of discussion, as the United States believes the case to be, that most of the European taxpayers that benefit from the qualified exemptions created by territorial limits are also exporters. This would mean, as a factual matter, that most of the universe of beneficiaries

for both the exemptions and the exclusion would be exporters who would realize the advantage of the exemption or exclusion by exporting.

70. The issue of law would then be whether, under those assumed facts, the exemption and exclusion are specific within the meaning of Article 2. In each case, a significant subgroup of the universe of beneficiaries would be exporters who could realize the benefit by exporting. As a matter of law, then, would the entire exemption or the entire exclusion be specific because a significant subgroup of the beneficiaries of each consists of exporters?

71. The answer to this question becomes clearer when one recalls that exporters are one type of "specific" group. Part II of the SCM Agreement is reached only in the case of programs that are "subsidies" under Article 1 and "specific" under Article 2. Article 1.2 expressly provides that if these two standards are not met, one does not reach Article 3. Exporters come within the Article 2 definition of "specific" because Article 2.3 expressly provides that subsidies that are contingent on export performance are "deemed to be specific." Thus, subsidies contingent on export performance are subsidies that are deemed to be subsidies that are "specific to an enterprise or industry or group of enterprises or industries" ("certain enterprises").

72. This construct, which the structure and the language of Articles 1 and 2 make clear, is helpful then in answering the Panel's question. If, as Article 2 specifies, export subsidies are one form of "specific" subsidy, then the question of law set forth above becomes easier to answer. Assume, for example, that the sub-group of the universe of beneficiaries was not exporters but rather was a group of industries, say, service industries, or natural resources industries. Assume also that the remainder of the universe of users was not a specific group of industries or enterprises. Would the subsidy be "specific" because one subgroup of the universe of beneficiaries, considered in isolation, was "specific"? The answer is, of course, no. To the contrary, the conventional way of making a specific subsidy non-specific is to expand the universe of users or beneficiaries. Once it is expanded beyond a specific group of "certain enterprises," it ceases to be specific.

73. For precisely the same reasons, a subsidy that is provided to a broad group of users is not specific because a subset of the users consists of exporters. Rather, the way to cure an export subsidy is to ensure that the benefit is provided to a larger group than just exporters; that is, to a non-specific group. (This was a question raised by the Panel in the original proceeding that the EC essentially refused to answer.)[36] It would be no more appropriate to find a subsidy specific by parsing the universe of users until one finds a subset of exporters than it would be to find a subsidy specific by parsing the universe of its users until one finds a subset of "certain enterprises." To do either would have the effect of draining all content from the Article 2 concept of specificity.

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[36] FSC (Panel), para. 4.1068, note 468.

74. For these reasons, the qualified exemptions created by territorial taxing limits should not be considered specific, for the same reasons that the new U.S. exclusion should not be considered specific.

75. On the other hand, if one were to accept the EC's standard for export contingency – which is that export transactions are taxed more favorably than comparable domestic transactions – then the United States believes that the subsidies described in the question would be specific, because these measures result in exports being taxed more favorably than comparable domestic transactions. Under Article 2.3 of the SCM Agreement, "[a]ny subsidy falling under the provisions of Article 3 [*e.g.*, any subsidy that is export contingent] shall be deemed to be specific."

Question 22. In the case of a FSC in existence on 30 September 2000, at what point in time would the unconditional legal right of a FSC-beneficiary to receive the tax reduction arise -- before or after 30 September 2000?

76. In the case of a FSC in existence on 30 September 2000, section 5(c) of the Act confers the legal right to a tax exemption by allowing the exemption despite the repeal of the FSC provisions effective on that date. This right, however, is not unconditional because it is subject to the conditions described in the Act.

Questions for both parties

Question 32. What is the relationship, if any, between the scope of Article III:4 of the GATT and Article 3.1(b) of the SCM Agreement -- is one necessarily broader than the other-- could a measure fall within the scope of one of these provisions, but not within the scope of the other? Please substantiate your response with reference to past GATT/WTO dispute settlement reports and other materials.

77. Article III:4 is broader than Article 3.1(b), so that a measure could fall within Article III:4, but not Article 3.1(b). This follows from the ordinary meaning of the terms used in the two provisions. Article III:4 speaks of "treatment no less favorable" and of requirements "affecting" internal sale, while Article 3.1(b) speaks of subsidies "contingent upon the use of domestic over imported goods." Based on the Appellate Body's interpretation of "contingent", this would seem to be a more difficult standard to satisfy than the standard of Article III:4.

78. The panel in *Canada Autos* reached a similar conclusion, stating in paragraph 10.215 as follows:

> We recognize that Article 3.1(b) in some sense has its roots in Article III:4 of GATT and in certain interpretations of that provision, which relates to non-discrimination. We do not consider however that Article 3.1(b) *ipso facto* has the same scope as Article III:4. To the contrary, while Article III:4 of GATT speaks of "treatment no less favorable" and of requirements "affecting" internal sale,

> Article 3.1(b) speaks of subsidies "contingent upon the use of domestic over imported goods." We are unwilling to import into Article 3.1(b) legal principles derived from the interpretation of a text which differs so markedly from that of Article 3.1(b).

This particular aspect of the report was not appealed.

Question 33. The EC states that "... the US review of its subpart F legislation is yet to be completed".[37] Please explain whether and how this statement is relevant to the current proceeding.

79. The statement by the EC is incorrect. The subpart F study was published in December 2000. If the EC had actually read the study, moreover, the EC would have recognized its irrelevance. The study deals with U.S. anti-deferral mechanisms, which have no particular relationship to any of the issues in this case.

Questions For the United States

Question 40. Please comment on paragraph 36 of the EC oral statement.

80. In paragraph 36, the EC made the following statement:

> The Appellate Body, in *Canada-aircraft*, stated that benefit does not exist in the abstract. In the same way, export contingency does not exist in the abstract; it must be analyzed with regard to the recipient, transaction and product concerned. The US approach would render the SCM disciplines completely ineffective.

81. To the extent that the EC is saying nothing more than that the existence of an export contingency under Article 3.1(a) of the SCM Agreement can be determined only on the basis of the measure or facts before a Panel, the United States cannot disagree with the proposition. However, the EC's claim that the Panel must focus on "the recipient, transaction and product" in a case it styles as a *de jure* one seems rather strange. Indeed, the quoted passage reflects a significant flaw that permeates the EC's case: its inability to base its arguments on the relevant text of WTO provisions and its resulting need to incorporate concepts and principles not found in that text to compensate for this fundamental deficiency.

82. For example, in paragraph 36, the EC cites a statement made by the Appellate Body regarding the term "benefit" and tries to apply it to "export contingency". This statement is reflective of a circular argument that flows from the schizophrenic approach taken by the EC in interpreting Article 3.1(a).

83. In paragraph 35 of its oral statement, the EC explained that:

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[37] **EC rebuttal submission, para. 29.**

> In the case of the FSC Replacement subsidy, the EC does not dispute the theoretical possibility for the benefit to become available without exporting. However, the fact that this possibility exists does not mean that all subsidies granted under the Act are not export-contingent.

Thus, paragraph 35 suggests that the EC is attacking the Act because (allegedly) particular transactions qualifying for the Act's exclusion may be export contingent.

84. However, in paragraph 4 of the *Preliminary Answers of the European Communities to the Questions of the Panel* (16 March 2001) ("*EC Preliminary Answers*"), the EC says that this is not what it is doing. In paragraph 4, the EC stated as follows:

> The EC is contesting a subsidy *scheme* (or *programme*) to use the word employed in the *SCM Agreement*), rather than individual subsidy *payments*. It is therefore the conditions of the *law* that need to be considered, not the "legal circumstances in which it is granted on a *case-by-case* basis." (Italics in original).

85. Fundamentally, the EC is trying to have it both ways. In one breath, it says its challenging the Act as a whole, but in the next breath tries to divide the Act into separate alleged subsidies. The EC needs to do this, of course, because the Act, when taken as a whole, simply cannot be regarded as export contingent, as that term has been interpreted by the Appellate Body, because a taxpayer can earn excluded income without ever exporting.

86. Moreover, as the United States previously has explained, the EC's analysis is analogous to an application of the "specificity" standard of Article 2 under which a government measure would be found specific because some subset of users within the universe of users constitutes a specific group. Such a result would be clearly erroneous.

87. Finally, the EC's assertion that "[t]he US approach would render the SCM disciplines completely ineffective" is circular and incorrect. It is circular because it assumes the answer to the question posed; *i.e.*, whether a "subsidy" that is not limited to exporters is export contingent because exporters are eligible. It is incorrect because one method of curing a prohibited export "subsidy" is to broaden eligibility so that the "subsidy" is no longer export contingent, as that term has been defined by the Appellate Body. Thus, SCM disciplines are not "ineffective" to the extent that they do not prohibit non-export contingent "subsidies."

Question 41. In paragraphs 110-114 of the US oral statement, the US argues that the EC's approach to interpreting footnote 59 "never attempts to analyze the ordinary meaning of the text". Why and how would the US analysis of "the ordinary meaning of the text" lead to a different conclusion?

88. The differing approaches taken by the EC and the United States to interpreting the fifth sentence of footnote 59 lead to different conclusions regarding the application of that provision to this dispute. The EC attempts to narrow the scope of the fifth sentence of footnote 59 in ways that its language simply does not allow. The EC tries to do so in a number of ways:

- First, the EC asks the Panel to adopt wholesale the provisions of the OECD Model Convention.
- Second, as a result of the EC's undue reliance on the OECD Convention, the EC maintains that a measure to avoid double taxation must require taxpayers to maintain a "permanent establishment" with respect to every country and every transaction that results in extraterritorial income.
- Third, the EC claims that foreign-source income is limited only to income that is directly attributable to foreign economic processes performed by the taxpayer.
- Fourth, the EC argues that a country may institute a measure to avoid double taxation only upon a showing that it is "necessary" to do so.
- Fifth, the EC suggests that a measure that allows an overall tax savings does not come within the fifth sentence of footnote 59 because it permits improper "overcompensation".

89. The United States disagrees with all of these points. This disagreement stems from the fact that the United States and the EC have taken very different approaches in interpreting the fifth sentence of footnote 59. Unlike the EC, which has turned to extrinsic sources for supplying meaning to the provision in question, the United States has focused on the ordinary meaning of the relevant text.[38] It is the United States rather than the EC that is employing the correct method of interpretation under public international law. This is not merely a theoretical distinction. It results in a starkly different meaning of the fifth sentence of footnote 59 as applied in this case.

90. The United States submits that the text of the fifth sentence of footnote 59 does not prescribe the *types* of measures that may be measures to avoid double taxation. It leaves it to individual WTO Members to determine the nature and methodology of measures to avoid double taxation. It also allows Members to take a prophylactic approach, rather than waiting for a double tax actually to be levied and providing relief only after the fact. This can be seen in the language of the fifth sentence of footnote 59, which says that paragraph (e) of Annex I does not "limit" the "ability" of Members" to take "measures" to "avoid" double taxation. Footnote 59's focus is on not limiting the ability of members to fashion double tax relief.

91. The flexibility accorded to Members is also reflected by the fact that the ordinary meaning of the fifth sentence of footnote 59 essentially says in one sentence what treatises and treaties are written to achieve. These topics are the subject of considerable debate among WTO Members.

92. As a result, the United States does not believe that there are internationally accepted "special meanings" that can be used to fill in any perceived "gaps" in footnote 59. It may be convenient for the EC to point to the OECD Convention to supply requirements and conditions that are not contained in the SCM Agreement, but such reasoning is simply not in accordance

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[38] *See U.S. First 21.5 Submission*, paras. 166-167.

with a proper interpretation under the Vienna Convention and the DSU. In contrast to the EC, the United States has cited these agreements only as evidence in support of its textual arguments. It has not attempted to substitute them for the text of the SCM Agreement.

93. Thus, respectfully, the Panel cannot assume that the concept of "permanent establishment" is a part of footnote 59. As the United States has explained, many countries do not rely on "permanent establishments" and have more aggressive tax systems. Even if it were part of footnote 59, there is no one internationally accepted definition of a "permanent establishment". The term "permanent establishment" as used in the OECD Convention can mean a fixed and enduring place of business, but it also can mean an agent acting on behalf of a non-resident. Moreover, it has a different meaning in the U.N. Model Agreement.

94. Indeed, one of the main reasons these agreements impose some "permanent establishment" requirement is because many countries tax non-residents who do not have "permanent establishments". WTO members should be able to protect their taxpayers from double taxation even where those taxpayers do not have a "permanent establishment" in a foreign country.

95. Likewise, the Panel should not read "foreign source income" as meaning only income directly attributable to foreign economic processes. Such a test is incompatible with the ordinary meaning of those words, which would seem to apply to income that has a foreign origin or comes from or is attributable to a foreign source. The EC not only is unable to explain why the words "foreign source income" have the unique meaning it advances, but the EC also cannot explain how foreign economic activities are to be valued or allocated. Furthermore, the wide application of double tax avoidance measures to passive income (dividends, interest, etc.), including in the EC, would not be proper under the EC's argument because there are no economic activities associated with such income.

96. The EC also is unable to explain why a WTO Member must demonstrate "necessity" to institute a measure to avoid double taxation. The SCM Agreement does not impose such a requirement. The drafters of the WTO agreements clearly knew how to impose a "necessity" requirement – they did so elsewhere – but did not in the fifth sentence of footnote 59. Moreover, the fact that a Member has one method to avoid double taxation does not mean that it cannot adopt another. That is a matter left to the Member to decide. Many countries, including France, offer taxpayers alternative methods.

97. Finally, the fifth sentence of footnote 59 does not require that Members provide double tax relief in manner that is precisely calibrated to offset – dollar-for dollar, pound-for-pound, or euro-for-euro – foreign taxes actually paid. The essence of the fifth sentence of footnote 59 is that it leaves Members unlimited in their ability to avoid double taxation. This means that such relief can be preventive in nature. That is why a number of countries rely on the exemption method for avoiding double taxation. Unlike the credit method, which provides relief based on the amount of foreign taxes paid, the exemption method looks to whether income could be taxed elsewhere. As the Commentary to the OECD Convention explains, "[f]undamentally, the

difference between the methods is that the exemption methods look at income, while the credit methods look at tax".[39]

98. Accordingly, the Act is a measure to avoid double taxation for purposes of the fifth sentence of footnote 59 because the ordinary meaning of that provision allows the United States to exclude from taxation income that could be taxed by another country. The transactions that give rise to extraterritorial income must involve the sale, use, or disposition of products outside the United States. The purchasers of such products may be foreign, title to the products may be transferred abroad, and any contracts involved may be executed outside the United States and may be subject to foreign law. In addition, the Act requires that at least a minimum amount of economic activities must occur abroad. In so crafting the Act, the United States has adopted a flexible approach to providing relief for its taxpayers against the myriad ways in which they might face double taxation.

Question 42. Is the EC correct in its statement that the "foreign economic process" requirements in Section 942(b) of the Act may be satisfied even where the functions were in fact performed within the United States? Please explain.

99. The EC is incorrect. Section 942(b) expressly provides that the Act's exclusion applies with respect to a particular transaction "only if economic processes with respect to such transaction take place outside the United States".[40] The Act does not allow this requirement to be met by performing the enumerated functions within the United States, as the EC asserts. As one of the legislative reports accompanying the Act's enactment explains:

> [u]nder the bill, gross receipts from a transaction are foreign trading gross receipts only if certain economic processes take place outside the United States. The foreign economic processes requirement is satisfied if the taxpayer (or any person acting under a contract with the taxpayer) participates outside of the United States in the solicitation (other than advertising), negotiation, or making of the contract relating to such transaction and incurs a specified amount of foreign direct costs attributable to the transaction. For this purpose, foreign direct costs include only those costs incurred in the following categories: (1) advertising and sales promotion; (2) the processing of customer orders and the arranging for delivery; (3) transportation outside of the United States in connection with delivery to the customer; (4) the determination and transmittal of a final invoice or statement of account or the receipt of payment; and (5) the assumption of credit risk.[41]

100. Merely because the taxpayer can arrange by contract for an agent to perform the activities on its behalf does *not* mean that the agent may perform the activities within the United States. That agent, for example, still must negotiate or solicit sales outside the United States on behalf of

[39] US-7.
[40] Section 3 of the Act, amending IRC Section 942(b)(1).
[41] *Senate Report*, pages 8-9, US-3.

the taxpayer. Accordingly, the United States is at a loss as to why the EC would contend that this requirement can be satisfied exclusively through domestic (U.S.) activities. The EC's assertion is contradicted by the language of the Act and the legislative report explaining it.

Questions For Both Parties

Question 43. Can a measure of a Member provided in respect of the production of a good outside the territory of that Member be a subsidy within the meaning of Article 1 of the SCM Agreement? Please explain your answer, taking into account any relevant provisions of the SCM Agreement.

101. Yes. Although the provisions of the SCM Agreement that address this issue in general terms are not entirely clear, certain paragraphs of Annex I clearly contemplate the provision of subsidies to recipients located outside the territory of the Member providing a subsidy. Thus, the United States does not disagree with the statement made by the EC in paragraph 65 of its First Submission.

102. At the outset, the United States notes that the reference in the question to "in respect of the production" may be somewhat inaccurate in light of the Appellate Body's recent decision in *United States - Lead Bar*.[42] Although the United States previously was of the view that subsidies are provided to productive operations, the Appellate Body rejected this approach, finding instead that subsidies are provided to natural or legal persons.[43]

103. With this as a background, there are several provisions of the SCM Agreement that arguably touch upon the question posed by the Panel. Article 1.1(a)(1) refers to "a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as 'government') ... ." The phrase "within the territory of a Member" arguably could modify either "financial contribution" or "any public body". However, the location of the parenthetical suggests that "within the territory of a Member" modifies "any public body", so that the public body providing a financial contribution must be within the territory of the Member allegedly providing a subsidy, but that the recipient of a financial contribution need not be within the territory of that Member. If the latter had been intended, the provision presumably would have read "a financial contribution *within the territory of a Member* by a government, etc."

104. Article 8.2(b) – which is no longer in effect – refers to "assistance to disadvantaged regions within the territory of a Member ... ." However, this provision does not shed any light on the Panel's question, because the reference to "territory of a Member" arguably simply limited

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[42] *United States - Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom*, WT/DS138/AB/R, Report of the Appellate Body adopted 7 June 2000.

[43] *Id.*

the circumstances under which a subsidy could be considered non-actionable, as opposed to the question of whether a subsidy existed at all.

105. Article 28.1 refers to "[s]ubsidy programmes which have been established within the territory of any Member ... ." However, this reference does not preclude the possibility that the recipient of a subsidy could be outside the territory of a Member.

106. Paragraph 6 of Annex IV – which also is no longer in effect – provided that subsidies provided by "different authorities in the territory of a Member shall be aggregated." However, this provision, like Article 1.1(a)(1), arguably refers to the location of the entity providing the subsidy, as opposed to the location of the recipient.

107. Finally, insofar as the concept of "territory" is concerned, paragraph 2 of Annex IV, which deals with the calculation of an overall rate of subsidization, provided *inter alia* that "the value of the product shall be calculated as the total value of the recipient firm's sales ... ." Footnote 63 to this paragraph stated that "[t]he recipient firm is a firm in the territory of the subsidizing Member." One can interpret this footnote two different ways. One interpretation is that it simply restates what is assumed in the remainder of the SCM Agreement; *i.e.*, that the recipient of a subsidy must be located within the territory of the subsidizing Member. Another interpretation, however, is that the footnote is necessary because it is *not* assumed in the remainder of the Agreement that the recipient must be located within the territory of the subsidizing Member. This latter interpretation would appear to be more in accordance with the principle of effectiveness of treaty interpretation.

108. Another relevant term is "jurisdiction", which in Article 2.1 refers to enterprises, industries or groups thereof "within the jurisdiction of the granting authority ... ." In the case of an alleged subsidy taking the form of a tax measure, it would seem appropriate to interpret the term "jurisdiction" as referring to the taxing jurisdiction of the Member in question.

109. Finally, certain provisions of Annex I involve practices that frequently entail the provision of a subsidy to a recipient located outside the territory of the Member providing the subsidy. In the case of export credits covered by paragraph (k), credits frequently are provided in the form of "buyer credits" that are received by a foreign person. Similarly, the types of subsidies covered by paragraph (j) often are provided to foreign persons.

110. Although U.S. countervailing duty practice is not binding on the Panel, the United States notes that the practice of the U.S. Department of Commerce is generally to treat what it calls "transnational subsidies" as non-actionable. In other words, a subsidy may exist when the government of one country provides a financial contribution to a recipient in another country, but Commerce does not countervail it. However, this policy is subject to certain exceptions.

Question 44. Assume for the sake of argument that the answer to question 43 is no. What relevance, if any, would such a conclusion have in respect of the issues of export contingency which are before the Panel in this dispute?

111. This conclusion would seem to be irrelevant for purposes of analyzing export contingency, and, indeed, could have unintended adverse consequences if it were considered relevant.

112. The fact that a particular financial contribution may be labeled as a "subsidy" when provided to certain recipients and as not a "subsidy" when provided to others would seem to have little relevance to the question of whether the measure is export contingent. Again, referring to the concept of specificity – of which export contingency is a part – helps to clarify things.

113. Assume a government loan program that provides loans to thousands of firms in a wide variety of industries at a standard interest rate of, say, 10 percent. For all loan recipients but one, the government financial contribution – in the form of a loan – does not provide a "subsidy" because there is no "benefit." More specifically, for all recipients but one, a 10 percent interest rate does not result in a difference between what the recipient pays on the government loan and the amount it would pay on a comparable commercial loan within the meaning of Article 14(b) of the SCM Agreement.

114. However, for one firm – which is in worse financial straits than other participants in the program – the interest rate of 10 percent *does* result in a difference, so that a subsidy exists. In analyzing whether this subsidy is specific, would one ignore the fact that loans on the same terms were provided to thousands of other industries, even though these loans did not technically satisfy the definition of "subsidy" under the SCM Agreement? The answer clearly has to be "no."

115. Thus, an analysis of specificity or export contingency which focused solely on those government outlays (or foregone revenue) that satisfied the technical definition of "subsidy" would generate peculiar and unintended results. In all probability, measures that previously were regarded as non-specific would be suddenly transformed into specific subsidies.

116. Indeed, insofar as the taxation of foreign-source income is concerned, an approach which focused on only one category of transactions capable of earning foreign-source income, such as exports, to the exclusion of other categories could result in labeling the tax regimes of most Members as subsidies. This follows from the fact that if, of the categories of transactions capable of generating foreign-source income, one excludes all categories involving products produced abroad, all one may be left with is the category of export transactions. Under the logic assumed in the question, the non-taxation (in whole or in part) of foreign-source income earned in export transactions automatically would be export-contingent, notwithstanding the fact that the tax rule applied to foreign-source income earned in export transactions is the same as the rule applied to foreign-source income earned in other types of transactions. The absurdity of this result demonstrates that this approach must be incorrect.

Question 45. Is export income foreign source income? Some may take the view that the "foreign-source income" referred to in footnote 59 should include export income since the footnote is accompanying item (e) that is dealing with a type of subsidy specifically related to export. Please comment.

117. Export income can and usually does involve some amount of foreign-source income. By their very nature, exports involve more than two countries in a business transaction. They can involve foreign purchasers, foreign use of the product, foreign sales and promotion activities, foreign distribution, foreign formation and execution of contracts, foreign passage of title, foreign origin of payment, and other foreign attributes. Some or all of these attributes can give rise to income being subjected to tax by a taxpayer's country of residence as well as another, or foreign, country.

118. Whether or not a country considers income taxable or not turns on domestic law. Countries around the world employ two sets of widely varying rules that may bear on this question: taxing jurisdiction rules and sourcing rules. With regard to jurisdiction, some countries tax businesses only if they have a fixed and enduring place of business that has active and even profitable operations, while others require some lesser presence and some require no fixed or established presence at all. With regard to sourcing, some countries would view a large portion of an export transaction as being "foreign", others a smaller part, and some relatively little. There is no internationally accepted rule establishing under what circumstances exporters may be taxed in the country to which their products are sent, and there is no rule governing which parts of income earned in an export transaction can be said to be "foreign".

119. Footnote 59's connection to paragraph (e) confirms that export income may be foreign-source income, at least in part. Paragraph (e) makes clear that "the full or partial exemption, remission, or deferral specifically related to exports, of direct taxes" is prohibited by Article 3.1(a). That the fifth sentence of footnote 59 provides that paragraph (e) does not limit the ability of Members to take measures to avoid double taxation of foreign-source income means that Members may do so even through an exemption, remission, or deferral that is "specifically related to exports". If export transactions do not produce "foreign source income" within the meaning of footnote 59, then it is hard to understand why the drafters inserted the fifth sentence into a footnote attached to paragraph (e).

Questions to the EC

120. The United States would like to comment on the following questions posed by the Panel to the EC.

Question 1. In section 3.2.5. of its first submission, the European Communities expresses the view that the FSC Replacement scheme gives rise to two distinguishable subsidies : the "basic FSC Replacement subsidy" and the "extended FSC Replacement subsidy".

- **Does this mean that the EC is requesting the Panel to make two separate rulings, one on each of the alleged subsidies?**

- **Does the EC consider that the application of a different portion of the FSC Replacement scheme may involve different types of subsidies under the SCM Agreement?**
- **Please identify the relevant portion of the *FSC Repeal and Extraterritorial Income Exclusion Act* ("the Act") framing these two "distinguishable" alleged subsidies.**
- **Does the EC believe that the status of a subsidy under the SCM Agreement is determined by the particular legal circumstances in which it is granted on a case-by-case basis?**

121. In the view of the United States, it would be inappropriate for the Panel to bifurcate the Act in the manner suggested by the EC. The EC would like the Panel to examine the Act as if it has one category for income derived from export transactions and another for income from all other types of transactions. As the United States has explained, the Act does not treat exports differently than other transactions that may give rise to extraterritorial income. There is a single exclusion that applies to different types of foreign transactions.

122. Instead of the artificial analysis the EC advances, the United States proposes that the Panel examine the measure as it is. The United States submits that the Panel should determine whether excluding (at least in part) extraterritorial income from a wide array of foreign sales, leases, and other transactions is a subsidy or an export subsidy (among other things). If the Panel were to adopt the EC's approach, it would in effect signal that the appropriate method for analyzing any tax exclusion or exemption of foreign income would be to first examine how it applies solely to exports, and then examine how it applies to other transactions. This approach would condemn many export-neutral tax measures simply because a sub-category of taxpayers subject to the measure happen to be exporters. This approach also would create an artificial distinction that is not supported by the text of the SCM Agreement and that does not exist with respect to the measure at issue.

123. Ironically, while the EC asks the Panel to divide what the Act does not, it takes the 50-percent value rule and attempts to integrate it into all aspects of the Act. Whereas there is no part of the Act that treats qualifying transactions differently, there is a separate provision of the Act that imposes the 50-percent rule. Because the Act institutes the rule through a stand-alone provision, the United States suggests that it is appropriate for the Panel to rule on the EC's claims concerning the rule separately. For example, if the Panel were to find that the Act confers subsidies or exports subsidies because of the 50-percent rule, the Panel should say so. The Panel should not condemn all provisions of the Act merely because it finds one potentially severable part to be problematic.

124. Thus, in reviewing the Act, the Panel should distinguish among its provisions where those provisions are separate within the architecture and design of the measure. The United States does object to imposing distinctions that the EC claims exist, but that cannot be found in the Act.

Question 3. The European Communities states that it "... sees no reason to contest that the last sentence of footnote 59 may be an exception to Article 3.1(a)."[44] Does this mean that the EC is of the view that measures satisfying the requirements for the last sentence of footnote 59 constitute "[m]easures referred to in Annex I as not constituting export subsidies" under footnote 5 of the SCM Agreement?

125. The United States respectfully refers the Panel to paragraphs 170-76 of its First Submission where it explained why, by virtue of footnote 5, a measure to avoid double taxation under footnote 59 is not prohibited by Article 3.1(a) or any other provision of the SCM Agreement. Neither the EC nor any third party has disputed this point.[45]

126. In this regard, several of the follow-up questions posed by the Panel to the EC appear to relate to the following: if the Act should be found export contingent by virtue of Article 3.1(a), rather than paragraph (e), would footnote 59 apply? In the view of the United States, the answer clearly is "yes."

127. Footnote 5 of the SCM Agreement reads as follows: "Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement." "[M]easures to avoid the double taxation of foreign-source income" are "referred to in Annex I [specifically, in footnote 59] as not constituting export subsidies ... ." Therefore, such measures are subject to footnote 5, regardless of the particular paragraph in Annex I to which footnote 59 is attached.

128. Any other outcome would have the absurd and perverse result that double taxation avoidance measures that are "specifically related to exports", within the meaning of the narrower standard of paragraph (e), are permitted, but comparable measures that are *not* "specifically related to exports" but nonetheless are export contingent under Article 3.1(a) are prohibited.

Question 5. Please provide further clarification of the point made in paragraph 227 of the EC second submission.

129. It is unclear to the United States how, under the Act, "income earned by a US company by distributing foreign goods may in large part be earned in the US." It would seem to the United States that, if a company is distributing foreign goods, it is doing so outside the United States. If a company is earning income by distributing goods for use within the United States, that income may not be excluded.

130. The United States is at a loss to understand how income earned from wholly-foreign transactions would not give rise to income subject to tax in a foreign jurisdiction and thus be

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[44] **EC second submission, para. 181.**

[45] The United States notes that in its first submission in *Brazil - Export Financing Programme for Aircraft - Second Recourse by Canada to Article 21.5 of the DSU*, WT/DS46 (2 March 2001), para. 54, note 42, Canada takes the position that footnote 59 is one of four provisions in Annex I that are subject to footnote 5. The United States adds that Canada, like the United States, routinely makes public its submission in WTO dispute settlement proceedings.

subject to double taxation. The United States notes that Canada has agreed with the United States on this point. As it stated in its submission, "the 'foreign income' component of 'extraterritorial income' is the type of income typically subject to a measure to avoid double taxation." Accordingly, it is entirely appropriate for the United States to provide relief from double taxation with respect to this income.

131. The United States also would note that the EC has focused throughout these proceedings on the case where the taxpayer's activities in the foreign jurisdiction do not amount to a permanent establishment. What the EC has ignored is that taxpayers can earn excluded extraterritorial income when the taxpayer's activities *do* amount to a permanent establishment. The Act would provide relief from double taxation in such a case, even under the EC's argument.

Question 6. The European Communities claims that the FSC Replacement scheme is a prohibited export subsidy contrary to Article 3.1(a) *and* item (e) of Annex 1 of the SCM Agreement. Are these alternative claims? In the EC's view, which claim must be addressed first by the Panel?

132. In the view of the United States, there is only a single obligation – not to provide export subsidies – and a single claim – that the United States has not abided by this obligation. The EC simply may be making alternative arguments to support what is really a single claim.